DESCRIPTION OF S. 1113 AND S. 1974

RELATING TO

STATE TAXATION OF MULTINATIONAL BUSINESS

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on September 29, 1986, on legislative proposals to limit State taxation of multinational business (S. 1113 and S. 1974).

Part I of the document is a summary.[1] Part II is an explanation of present law regarding State and Federal taxation of multinational corporations and State taxation of interstate business transactions. Part III provides a discussion of possible Federal limitations on State taxation of foreign source income. Part IV sets forth the principal issues involved. Part V is a description of the provisions of S. 1113, and Part VI is a description of S. 1974.

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1 This document may be cited as follows: Joint Committee on Taxation, State Taxation of Multinational Business (JCX-27-86), September 29, 1986.

I. SUMMARY

State taxation of corporations

At present, States generally tax the income of corporations doing business within and outside the State by apportioning the income pursuant to a formula--this is commonly referred to as the unitary method. The States have adopted several different approaches to apply the unitary method to apportion the income of affiliated groups of corporations. Some States take into account the operations of foreign affiliates of the corporation doing business in the State to the extent that the foreign affiliates and the U.S. corporation are engaged in phases of a single "unitary" business. The practices of States in taxing dividend income from affiliated corporations also vary, depending in part on whether the income from which the dividend was paid was already subject to tax pursuant to apportionment. These State rules for determining the amount of income subject to tax differ in a number of respects from the methods employed by the Federal Government in determining the tax liability of multinational corporations.

Federal limitations on State taxation of corporations

Although the Constitution imposes some limitations on State apportionment methods, the States generally have considerable flexibility in determining their rules. The Congress in 1959 enacted limited legislation dealing with State jurisdiction to tax, but has not prescribed any additional rules.

Legislative proposals

S. 1113

S. 1113 (introduced by Senator Mathias) would limit the manner in which States could tax income of foreign affiliates. Under the bill, States and localities would generally be prohibited, in applying their income tax to a corporation, from taking into account the income of any related foreign corporation. The provisions of the bill would apply regardless of whether the parent corporation of the group is foreign or domestic. In addition, the bill would limit the ability of States and localities to apply an income tax to dividends received by a corporation from foreign corporations or U.S. corporations, substantially all of whose income is from foreign sources. Generally, some or all of the dividends would be exempted from State taxation in order to take into account foreign taxes paid on that income. A separate exemption is provided in the case of dividends from corporations making an election under Code section 936. The bill would be effective for taxable years beginning after

1986.

S. 1974

S. 1974 (introduced at the request of the Administration by Senators Wilson, Mathias, and Hawkins) would prohibit State use of the worldwide unitary combined reporting method. The bill would allow use of the combined reporting method for corporations within a water's edge group, consisting generally of corporations, both U.S. and foreign, with some threshold level of U.S. activity. The bill would limit State taxation of foreign source dividends (except in the case of the State of legal or commercial domicile). Further, the bill would impose reporting requirements on corporations subject to State tax, and would provide for sharing of Federal information with States. The bill would be effective for taxable years beginning after 1986.

II. PRESENT LAW

A. State Income Tax

1. Unitary method of apportionment for State taxation of corporate income

The question of State taxation of foreign source income is one aspect of the larger question of State taxation of businesses operating in more than one State. This larger question involves the problem of determining a State's jurisdiction for taxing a corporation's income and rules for apportioning and allocating that income among the States in which a corporation does business. Of the 45 States which impose a corporate income tax, all use some kind of formula to apportion business income between the various States in which a corporation operates. However, the specific formula used varies substantially from State to State.

In 1969, a group of States reacted to the possibility of Federal legislation (which would have required greater uniformity in apportionment) by adopting a multi-state tax compact, which established the Multistate Tax Commission whose duties are to establish uniform income tax regulations, auditing standards, and tax forms for member States. The Commission also established uniform rules regarding the allocation and apportionment of State corporate income. Presently, 19 States are members of the compact (the majority of the States are Midwestern and Western States). Under the compact, the regulations of the Multistate Commission are effective in all member States, but any member State can adopt overriding regulations if it chooses. Since most of these States have adopted some overriding regulations, the methods of taxing corporations still vary among States which are members of the compact. (The authority of the Multistate Tax Commission to operate as agent of the States in enforcing their corporate income tax laws was upheld by the U.S. Supreme Court in United States Steel Corp v. Multistate Tax Comm'n, 434 U.S. 452 (1978).)

Unitary method

The unitary method requires two steps for the apportionment of income to a particular State. First, the total amount of income subject to apportionment is determined. Second, the apportionable income is multiplied by a formula intended to reflect the portion of that income earned within the State. The resulting product is subject to the State's taxation.

Formula.--In determining income earned within a State, most States use some variation of a basic three-factor apportionment formula. Under this formula, the income of a

business is apportioned to each State according to the average ratio of three factors: the ratio of sales, payroll, and tangible property values of the business in the State to the respective sales, payroll, and tangible property values of the total business. For example, a corporation which has one-half of the value of its tangible property, three-fourths of its payroll, and one-fourth of its sales in a particular State would take the average of these three fractions to determine the amount of income subject to tax in that State.[2]

Apportionable income.--A State's apportionment formula is applied only to that income of a corporation which is from a unitary business. In general, a corporation has a unitary business when the business activity from within the State is dependent upon, or contributes to, business activities of the same corporation outside of the State. Where the business activity in the State is unrelated to other businesses of the corporation outside of the State, so that there is no unitary business which is conducted in part within and in part outside of the State, all of the income from that business within that State is allocated to, and thus is taxed by, that State, and the income from the other businesses conducted outside the State is not allocated to, or taxed by, the State. Virtually all States include the income, and tangible property, payroll, and sales of foreign branches of domestic corporations in the income which is subject to their apportionment formula.

In general, a unitary business is considered to exist where, for example, a product is manufactured in one State and sold in another State, or where a product is partially manufactured in one State and then shipped to another State where the manufacturing is completed. The requirement to apportion income derives from the difficulty in determining how much of the total net income is attributable to the manufacturing operation and how much to the sales activity, in the first situation, and to the two manufacturing operations, in the second situation. However, such direct integration of business operations is not the sole criterion that has been used by the States to establish the existence

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[2] Those States which do not follow this three-factor formula use other apportionment formulas, some based on sales only and others based on a combination of sales and property or sales and payroll or property and payroll. Even among those States which do use the three-factor formula, the manner of measuring the three items in the formula may differ. For example, in some States a sale is taken into account by the State where the sale originated (generally, the location of the seller) while in other States the sale is allocated to the State of destination (generally where the buyer is located).

of a unitary business. In some cases, the touchstone for establishment of a unitary business has been centralized management or centralized purchasing. A unitary business also has been held to exist where the home office used the assets of an otherwise unrelated business operation as collateral for a loan and, with respect to investment securities, where the securities were purchased from operating income.

In many States, not all of the income of a corporation is subject to that State's apportionment formula. For example, in some States passive income such as dividend income is allocated entirely to the State of the "commercial domicile" (generally the State of the principal business location) of the corporation and is thus excluded from the income subject to the apportionment formula.

Combined reporting

The States have adopted several different approaches to apply the unitary method to apportion income of affiliated groups of corporations (parent, subsidiary, and brother-sister corporations). Some States apportion on a corporation by corporation basis, and the income and business operations of affiliated corporations are not taken into account even where those operations are directly related to the business operations of the affiliates operating within and taxed by the State. However, most States in at least some circumstances combine (either mandatorily or at the taxpayer's election) the income and related business operations of some or all affiliated corporations which operate a unitary business. The combined income is then apportioned within and outside of the State in accordance with the combined property, payroll, and sales factors for the unitary business of the group within and outside of the State. Application of the unitary method in this manner is referred to as "combined reporting" and is analogous to the filing of a consolidated return for Federal tax purposes.

Worldwide combination.--Most States which use the combined reporting approach of applying the unitary method in the case of affiliated groups typically limit the affiliated corporations included in the combined report to the U.S. corporations within the group and, as in the case of Federal consolidated return provisions, the operations of foreign corporations are not taken into account. However, a few States include the operations of foreign affiliates in the combined report where those operations are dependent upon or contribute to the activities of the U.S. affiliates within the taxing State. This generally is referred to as the application of the unitary method on a "worldwide combination" basis. Some of these States require the inclusion of foreign affiliates involved in the unitary business as a matter of course; others include foreign

affiliates only on occasion. In applying the unitary method on a worldwide combination basis, the income of foreign affiliates is treated in much the same manner as most States treat income of foreign branches of U.S. corporations.

Considerable controversy has surrounded the requirement by these States that the operations and income of foreign affiliates be included in the combined report. The proposed legislation which is the subject of the current hearings (see Parts V and VI of this document) is directed at this application by States of the unitary method on a worldwide combination basis.

2. State taxation of dividends from foreign corporations

Almost all States impose a corporate income tax on foreign source dividends in at least some situations. A few States completely exempt dividends, or at least all dividends received from foreign corporations (including deemed dividends of tax haven income taxable for Federal income tax purposes under subpart F of the Code). Some of the States which do tax dividends do not include the dividends in the income to be apportioned by the unitary method among the States. (This is particularly the case where the dividends received from a subsidiary do not arise out of earnings from business operations of the subsidiary which are related to those carried on in the State by the U.S. corporation.) These States generally allocate the dividends, and thus jurisdiction to tax, entirely to the U.S. corporation's State of commercial domicile.

In those States where the income and payroll, sales, and property factors of the foreign subsidiary are taken into account through worldwide combination in determining the income of the U.S. parent to be apportioned to the taxing State, dividends distributed by the foreign corporation out of the unitary business are not included in the income to be allocated or apportioned so as not to be taxed twice by the State. However, dividends which are not out of the unitary business income which has been taken into account in computing the U.S. corporation's apportionment formula are included in income and are taxed when distributed. In other States where dividends from a foreign subsidiary carrying on a unitary business with the U.S. parent are subject to tax, but where the foreign subsidiary's income is not subject to tax as it is earned pursuant to a combined reporting method (e.g., the Vermont system considered in the Mobil case), dividends may be included in income and apportioned in accordance with the payroll, sales, and property factors of the U.S. corporation (which would allocate to the State a higher portion of the income being apportioned since the foreign factors are not taken into account). The rationale for apportioning such a dividend is that the income from which the dividend is paid was not previously subject to tax.

3. Comparison with Federal taxation of multinational corporations

In general

For Federal income tax purposes, U.S. corporations (those incorporated in the United States) are taxable on their worldwide income--both from sources within and outside of the United States. The United States does, however, cede primary tax jurisdiction on foreign source income to foreign governments by the allowance of a credit for the foreign income taxes paid on foreign source income. (The foreign tax credit is limited to the precredit U.S. tax attributable to foreign source income). The foreign tax credit is allowed for foreign income taxes imposed by provinces, cities, and other political subdivisions as well as those imposed by national governments.

The Federal rules applicable to foreign corporations (those incorporated outside the United States) are more directly analogous to the State rules previously discussed--foreign corporations generally are subject to Federal income tax only on their U.S. source income. This generally is true even in the case of foreign subsidiaries of a U.S. corporation--their foreign income is not taxable by the United States directly. However, if and when the income earned by a foreign subsidiary is distributed (or deemed distributed) as a dividend, the dividend is taxable to its U.S. shareholders. U.S. corporate shareholders with at least a 10-percent ownership interest in the foreign corporation are allowed an indirect foreign tax credit for their portion of the foreign taxes paid by the subsidiary which are attributable to the dividend.

The Federal rules do not follow the approach generally used by the States of aggregating all the income of a business and then apportioning it in accordance with a single formula to determine taxable income from sources within the State. Instead, as outlined below, the Federal system attempts to determine taxable income on an item-by-item basis.

Section 482

U.S. corporations are fully taxable by the United States on their worldwide income while their foreign affiliates (either foreign subsidiaries in the case of a U.S. multinational or foreign parent and affiliates in the case of foreign multinationals) are generally taxable only on their U.S. source income. Thus, there is an incentive for U.S. corporations to divert income to their foreign affiliates by distorting intercompany transfer prices. To limit this potential, Internal Revenue Code section 482 authorizes the

Internal Revenue Service to distribute, apportion, or allocate gross income, deductions, credits, or allowances between related entities if the IRS determines that it is necessary in order to prevent evasion of taxes or clearly to reflect income.

In 1966, regulations were issued interpreting section 482 which generally provide that in any transaction among members of a controlled group of corporations, the affiliate receiving a benefit from a related corporation must make adequate reimbursement for the benefit. The regulations provide detailed standards for determining whether the intercompany pricing arrangements are adequate--the rules cover the pricing of sales of tangible property by one member of a controlled group to another, the use by one affiliate of the intangible property (patents, copyrights, trademarks, know-how, etc.) owned by another, intercompany loans, services provided by one affiliate to another, and other intercompany transactions. The rules generally apply an arm's-length standard--that is, they generally require that the intercompany pricing be the same as the prices which would be charged between two unrelated companies.[3]

This arm's-length standard is essentially the same standard used by other countries to govern the intercompany pricing arrangements of multinational corporate groups operating within their jurisdiction. This method also is used by those States which do not include foreign affiliates in the combined report. Since these States generally apportion (and thus tax) only the income of the U.S. members of the group, it is important that the income of the U.S. affiliates is not artificially diverted to non-taxed foreign

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[3] The House-passed version of the Revenue Act of 1962 contained an amendment to sec. 482 which provided special rules for allocating taxable income arising from sales of tangible property within a related group which includes foreign corporations. The allocation was to be made by taking into consideration that portion of the payroll, property, expenses, and other factors of the group attributable to the United States. Although this method is somewhat analogous to the application of the unitary method on a combined reporting basis, it was to be applied only with respect to income from intercompany sales rather than with respect to the entire operations of the group. The provision was deleted from the bill as finally enacted because the conferees agreed that Treasury had the authority to prescribe under section 482 rules which would accomplish that objective, and Treasury was directed to explore the possibility of promulgating regulations which would do so. As noted above, the regulations promulgated in response to this direction generally adopted a different approach.

affiliates. As a practical matter, these states rely on the Internal Revenue Service to police the intercompany pricing of multinationals. This method contrasts with the combined reporting methods used by many states, under which intercompany pricing is not relevant because the income and deductions of the affiliated companies are combined and apportioned pursuant to a formula. In much the same way, intercompany pricing generally is not important for federal tax purposes in the case of transactions between U.S. corporations included in a consolidated return.

Allocation and apportionment of income and deductions

The rules for determining whether the income of a taxpayer is from sources within or outside of the United States are set forth in Code sections 861 through 864. As indicated above, the source of taxable income is important in the case of a U.S. corporation because its foreign tax credit is limited to its pre-credit U.S. tax allocable to its foreign source income, and it is important in the case of a foreign corporation because its U.S. tax is based on its income from U.S. sources.

These rules operate by first specifying a particular source for the various items of gross income earned by the taxpayer (interest and dividends received from U.S. corporations generally are treated as U.S. source income; income from the performance of services generally is sourced where the services are performed, etc.). After the source of the various items of gross income has been determined, taxable income from sources within and outside of the United States is determined by deducting from each the expenses, losses, and other deductions properly apportioned or allocated to each, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (Code secs. 861(b) and 862(b)).

The regulations (Treas. Reg. sec. 1.861-8) set forth detailed rules for the allocation and apportionment of deductions to U.S. and foreign source gross income. These rules provide in certain circumstances for the apportionment of deductions of a U.S. corporation on the basis of assets or sales of all corporations within the controlled group, including the foreign subsidiaries. The Tax Reform Act of 1986 (H.R. 3838) would, if enacted, require a U.S. affiliated group to apportion interest expense and certain other expenses as if the U.S. group were one corporation.

B. Worldwide Unitary Taxation Working Group

In response to concerns expressed by the U.S. business community and major U.S. trading partners in connection with

worldwide unitary combination, the Administration organized a Cabinet Council on Economic Affairs (CCEA) Working Group in July, 1983, to develop possible options and recommendations on this issue. The CCEA Working Group was composed of members of various Federal departments and agencies. The working group issued a series of options to President Reagan in September 1983, one option of which was its recommendation to establish a working group which would include representatives of the business community, Federal Government, and State governments to study the issue further and attempt to achieve coordinated solutions to the problems created by the worldwide unitary method of taxation.

The Worldwide Unitary Taxation Working Group held several meetings from its establishment in September 1983 through May 1984. The working group was unable to reach a consensus on some issues, but it did establish a set of principles that were intended to guide States in developing legislation subjecting multinational corporations to State income tax. The three principles on which the working group reached a consensus are: (1) provide water's edge limitation on unitary combination for both U.S. and foreign companies; (2) increase Federal administrative assistance and cooperation to assure full disclosure and accountability of taxpayers; and (3) balance the competitiveness of U.S. multinationals, foreign multinationals, and purely domestic businesses.

In August 1984, the Secretary of the Treasury submitted a report to President Reagan containing the three principles agreed to by the working group, plus an explicit statement of disagreement on two issues. The report indicated that the three principles, other than the Federal assistance principle, should be implemented on a State-by-State basis, rather than by Federal legislation. The two issues on which the working group was not able to achieve a consensus were the proper tax treatment of foreign source dividends by the States, and whether domestic corporations with predominantly foreign operations (commonly referred to as "80/20 companies") should be includible in a unitary group. The report indicated that those issues were to be resolved by each State, taking into account the competitive balance principle proposed by the group. Finally, the report indicated that the Treasury Department would recommend to the President that the Administration propose Federal legislation that would require a water's edge limitation to the unitary method if the States did not show sufficient progress by July 1985 in incorporating in legislative or administrative action the principles set forth by the working group.

On July 8, 1985, the Treasury Department released proposed legislative language designed to implement the recommendations of the Working Group. Although parts of that July 1985 proposal are incorporated in S. 1974, described in

Part VI, below, S. 1974 differs substantively from that proposal.

C. Recent State Legislative Action

When the Worldwide Unitary Taxation Working Group was established, 12 States based their unitary method on some form of worldwide combined reporting.[4] At the present time, all but three of these States, Alaska, Montana, and North Dakota, have stopped requiring worldwide combined reporting.

California, the State with the longest experience in worldwide combined reporting, is the most recent State to modify its worldwide unitary method. California legislation (SB 85), enacted September 5, 1986, allows corporations to continue computing their State tax liability under either the present law worldwide unitary method or under a new "water's-edge" unitary method. Thus, corporations with a unitary business in California can either continue to include all affiliated corporations in the combined group or only those corporations considered to be within the water's edge. The legislation treats the following corporations as within the water's edge: (1) any corporation eligible to be included in a Federal consolidated return; (2) Domestic International Sales Corporations and Foreign Sales Corporations (as defined in Internal Revenue Code secs. 992(a) and 922, respectively); (3) any corporation that has an average three-factor formula (sales, property, and compensation) percentage of 20 percent or more assignable to a location in the United States; (4) any U.S. corporation other than a possessions corporation if more than 50 percent of the stock is commonly controlled; (5) any other corporation, but only to the extent of its income derived from, or attributable to, U.S. sources and factors assignable to U.S. locations, as computed under a separate accounting; (6) Export Trade Corporations (as defined in sec. 971(a)); and (7) controlled foreign corporations (as defined in sec. 957) but only to the extent of such corporations' subpart F income (as defined in sec. 952). In addition, U.S. branches of foreign banks are treated as separate corporations. Corporations that elect the water's edge unitary method are subject to a fee of .03 percent of their sales, property, and payroll assignable to California. The election also requires that corporations submit to certain reporting requirements. Other provisions of the legislation include a provision equivalent to IRC section 482, a 75 percent exclusion for certain foreign dividends in computing apportionable income, and limits on the installment method of accounting and reserve method for computing bad debts.

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[4] These States are Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon, and Utah.

III. FEDERAL LIMITATIONS ON STATE TAXATION OF FOREIGN SOURCE INCOME

A. Constitutional Limitations

A number of recent Supreme Court cases are particularly relevant to constitutional limitations on State income taxation.

Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978)

Moorman dealt with the application of the unitary method in connection with interstate, rather than foreign, commerce, but it would appear to be of general application. The case sustained Iowa's single-factor sales formula for apportioning income against a constitutional challenge. The Court first held that there had been no violation of the Due Process Clause. The Court rejected Moorman's argument that it was unconstitutionally taxed on the same income by both Iowa and Illinois because Moorman could not prove, under a separate accounting analysis, that Iowa taxed its out-of-State income. The Court held that it was not necessary for a State's apportionment formula to result in tax on no more than the exact amount of income earned in the State. Generally, a State tax would be upheld so long as there was at least a minimal connection between the activities being taxed and the values of the enterprise there. A single-factor formula would presumptively meet the second test, unless there were clear evidence in a particular case that the results were grossly distorted. The Court ruled that Moorman had made no such factual showing.

The Court also held that, in the absence of an actual showing of double taxation, it would not find that Iowa's formula violated the Commerce Clause. The Court declined to hold that the formula must be invalidated if there were a mere possibility of double taxation, pointing out that this would require the Court to prescribe in detail a single uniform allocation formula by which all the States would be bound. The Court did indicate, however, that the legislative power granted to the Congress under the Commerce Clause would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income.

Japan Lines, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)

In this case, the Court considered whether or not a California property tax imposed an unconstitutional burden in cases where the tax was imposed on ships' cargo containers which were utilized exclusively in foreign commerce. The containers were owned, based and registered abroad. In finding that the tax was unconstitutional, the Court held

that it was not enough that the tax meet the requirements applicable to State taxation of instrumentalities of interstate commerce: that the tax be on an activity with a substantial nexus to the taxing State, be fairly apportioned, be nondiscriminatory, and be fairly related to services provided by the State. Rather, the Court observed that there were two additional considerations where instrumentalities of foreign commerce were involved. First, multiple taxation was a greater possibility because no one tribunal was available to reconcile the claims of the competing taxing jurisdictions. Second, the State tax might prevent the United States from speaking with one voice when regulating commercial relations with foreign governments. The Court held that California tax failed both of these tests.

Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980)

Under the Vermont tax system, foreign source dividends received by a U.S. corporation doing business in Vermont are included in the income subject to apportionment pursuant to Vermont's three-factor formula and the amount apportioned to Vermont is subject to its corporate income tax. Mobil challenged taxation by Vermont of the foreign source dividend income received by Mobil from its affiliates. (These were generally foreign corporations, although dividends from Aramco, a U.S. corporation operating in Saudi Arabia, were also involved.) Mobil argued that the dividend income should instead be allocated in its entirety to New York, the State of its corporate domicile. (Under New York law, however, the foreig- dividend income would be exempt from State tax.)

The Court first held (citing Moorman) that the Vermont tax did not violate the Due Process Clause of the Constitution because there was at least a minimal connection between Mobil's activities and Vermont and because there was a rational relationship between the income attributed to Vermont and the activities in Vermont. These criteria were met with respect to the apportioned dividend income because it represented the earnings of Mobil's unitary petroleum business. In this regard, the Court looked to the underlying activities of the subsidiaries.

The Court also held that the Vermont tax did not violate the Interstate Commerce Clause of the Constitution because the four criteria for State taxation (outlined above in the discussion of Japan Lines) had been met. Mobil failed to show that Vermont's apportionment resulted in double taxation because New York did not tax the dividends. In the absence of actual multiple taxation, the Court found no reason to require Vermont to switch from its apportionment method to a method which would allocate the dividends entirely to New York.

Further, the Court found no violation of the Foreign Commerce clause. Mobil took the position that the dividends should be taxable only in the jurisdiction of domicile, on an analogy to Japan Lines, in which the Court had held that the containers should only be taxable in Japan. The Court observed, however, that Mobil's case did not involve international double taxation; rather, Mobil was arguing that double taxation might occur as among the states. However, such double taxation would be within the power of the Court to remedy, so the special considerations of Japan Lines on this point were not applicable. The Court further declined to hold that considerations of Federal tax policy required Vermont not to tax the dividend income, in the absence of an explicit directive from the Congress.

Mobil argued in its reply brief that, if its dividends from its affiliates were to be included by Vermont in income subject to apportionment, then the property, payroll and sales of those affiliates should be taken into account in determining the amount of income apportionable to Vermont. (This method would be similar to the combined reporting method then in effect in California.) The effect of including the property, payroll and sales of the affiliates in the apportionment fraction would have been to reduce the income apportionable to Vermont, because the activities of these affiliates were outside the state. However, the Court held, on procedural grounds, that Mobil had waived its right to advance this argument. Accordingly, the Court made no decision as to whether this combined reporting would be constitutionally required. This holding as to the procedural posture of the case was in large part the basis of dissent by Justice Stevens, who argued that consideration of the property, payroll, and sales of affiliates in the apportionment fraction would be required if Vermont sought to tax Mobil's dividend income from those affiliates.

Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980)

Relying heavily on the Mobil case, the Supreme Court held that Exxon's three separate functional departments (exploration and development, refining, and marketing) constituted a unitary business whose income was subject to apportionment under Wisconsin law. Exxon had argued that since its functional departments were separate profit centers that had separate accounting and made intercorporate transfers at market wholesale prices, and since only its marketing function had contact with Wisconsin, its tax liability to Wisconsin should be based upon the separate accounting income of the marketing function (which incurred a loss for the four years at issue).

The Court held that the application of Wisconsin's appointment formula to the income of Exxon's entire group of

functional departments did not violate the Due Process Clause of the Constitution, which required that there be a minimum nexus between Exxon's activities and the State of Wisconsin, and that there be a rational relationship between the income attributed to Wisconsin and the intrastate values of Exxon within the State. The first requirement was met by virtue of Exxon's marketing activities within the state. However, Exxon argued that its separate accounting established that the tax imposed under Wisconsin's apportionment formula was out of all proportion to Exxon's business activities within the State and, therefore, Wisconsin's apportionment formula did not satisfy the second Due Process requirement.

The Court responded to Exxon's argument generally by stating that separate accounting as a measure of an enterprise's true income from within a State was not constitutionally required because it may fail to account for contributions to income from such things as centralized management and economies of scale. The Court held that in the case of a unitary business, apportionment is the appropriate method of measuring the income that is reasonably related to the activities conducted within the State. The Court further held that in order to be excluded from the apportionment formula, income must be earned in activities unrelated to the activities carried on within the taxing State. In making this determination the Court would look "to the 'underlying economic realities of a unitary business' and the income must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise.'"

Exxon made a second Due Process argument that its income from the sale of crude oil and gas at the wellhead should be allocated to the situs State rather than be subject to apportionment. Wisconsin agreed to the extent the oil and gas were sold to third parties. Therefore, the only issue before the Court was the treatment of intercorporate sales of crude oil and gas within Exxon itself. The Court held that this activity was part of the unitary business and, accordingly, the income should be included in the apportionment formula. (The Court specifically stated that it was not addressing the issue of whether the Due Process Clause would require that the income from the third party sales of crude oil and gas be allocated to the situs State rather than apportioned.)

Further, the Court rejected Exxon's argument that the Interstate Commerce Clause requires that Exxon's income from exploration and production of oil and gas be allocated to the situs state. Essentially, the Court held that those qualities that make Exxon's activities a unitary business also satisfy the requirements of the Commerce Clause that the tax (1) be applied to an activity with a substantial nexus with the taxing State, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly

related to the services provided by the State.

Container Corp. of America v. Franchise Tax Board, U.S. 103 S. Ct. 2933 (1983)

In the case of a "unitary" business, the California tax system applies a three-factor formula (property, payroll, and sales) on a worldwide basis to determine the portion of the worldwide income of a multinational enterprise that that State subjects to tax. (California has repealed the requirement that multinational enterprises use this method, but only for taxable years beginning after 1987 (see discussion below).) The Supreme Court held that that California system, as applied to a multinational enterprise headed by a domestic corporation, was not so inaccurate as to violate the constitutional requirement of fair apportionment under the Due Process and Commerce Clauses. The Court found that the three-factor formula necessarily was imperfect, but it found no evidence that the margin of error in that three-factor formula was greater than that inherent in section 482-style separate accounting (the alternative that the taxpayer contended was constitutionally mandated). In addition, the Court found that, under the Foreign Commerce Clause, the three-factor formula did not improperly impair Federal uniformity and was not pre-empted by Federal law then in effect. The Court did not address the application of the California system to foreign-based multinational enterprises.

B. Prior Congressional Action

In response to U.S. Supreme Court decisions in the late 1950's upholding the power of States to tax income from interstate commerce, Congress enacted Public Law 86-272 (15 U.S.C. secs. 381-384). That law provides that, in general, no State or locality may impose an income tax on any person engaged in interstate commerce if the only activities of the person in the State are the solicitation of orders for tangible personal property which are sent outside the State for acceptance and are filled by shipment from outside the State. For this purpose, a person is not treated as engaged in a business within the State merely by reason of the sales activities of independent contractors.

Subsequently, a number of bills were introduced which would have mandated greater uniformity in the rules for State taxation of corporations. Two of these bills passed the House of Representatives,[5] but no further action was taken.

C. Recommendations of 1977 Ways and Means Task Force on Foreign Source Income

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[5] H.R. 2158 (90th Cong.) and H.R. 7906 (91st Cong.).

The Ways and Means Committee, in the Tax Reform Act of 1976, agreed to a number of major changes which would have produced significant revisions in the taxation of foreign source income. In addition, there were several other proposed changes in the taxation of foreign source income which were considered by the committee but which the committee decided needed further study. Therefore, the committee established a task force to analyze the issues involved and to recommend to the full committee any appropriate legislative changes.[6] The proposals referred to the task force included proposals to limit the manner in which States could take into account the operations of foreign affiliates of U.S. corporations.

The task force made the following recommendations with respect to State taxation of foreign source income:

(1) Income of foreign affiliates not subject to Federal income tax.--It was recommended that the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income was subject to Federal income tax. (The provisions of S. 1113 and S. 1974 prohibiting the application of the unitary method on a worldwide combination basis generally follow this recommendation, with further limitations on taxation of foreign source dividends. See Parts V. and VI. below.)

(2) Income of foreign affiliates subject to Federal income tax.--It was recommended that no limitation be placed on the power of States to apply the three-factor formula on a domestic basis, under the unitary method or otherwise, to income of foreign affiliates which had been excluded under paragraph (1) above if and when such income became subject to Federal income tax.

D. Treaties

U.S.-U.K. Treaty

As originally negotiated, Article 9(4) of the tax treaty between the United States and the United Kingdom would have prevented the Federal Government and the States from extending the unitary method on a worldwide combination basis to related foreign enterprises where the enterprise doing business in the State was either a British enterprise or a

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[6] The task force was comprised of 10 members of the Ways and Means Committee, with Mr. Rostenkowski as chairman. It submitted its report on March 8, 1977.

U.S. corporation controlled directly or indirectly by a British enterprise. Thus, for example, if a U.S. branch of a British corporation did business in a State, that State could not apply the unitary method to combine the income (and sales, payroll, and property) of any related foreign enterprises (from the United Kingdom or any third country) with those of that British corporation in determining the income of its U.S. branch which is taxable by that State. Alternatively, if the British corporation did not do business in the State, but had a U.S. subsidiary doing business in the State, that State, in determining the taxable income of that U.S. subsidiary, could not apply combined reporting requirements to include the income (and the sales, payroll, and property factors) of the British parent corporation or other related foreign enterprises.

When the treaty was first considered by the U.S. Senate, Senator Church proposed a reservation which would have had the effect of deleting from the treaty this provision as applied to the States. The reservation lost on the Senate floor by a vote of 34 yeas, 44 nays. However, the Senate thereafter, by a vote of 49 yeas, 32 nays, failed to concur in the proposed treaty containing the State taxation provision by the required two-thirds vote (ratification would have required an affirmative vote of 54 of the 81 Senators voting). After the Treasury Department announced that it would accept the treaty with a reservation deleting the limitation on the States, the Senate reconsidered the treaty and gave its advice and consent to ratification of the treaty, subject to the Church reservation, by a vote of 82 yeas, 5 nays. The reservation was subsequently incorporated in a protocol to the treaty, which was approved by the Senate on a unanimous vote of 98 yeas. In its report on the protocol, the Senate Foreign Relations Committeee urged the tax-writing committees of the Congress to hold hearings on the issues presented by Article 9(4) of the U.K. treaty.[7]

On July 10, 1985, the British House of Commons approved a measure that eventually would, on implementation, allow the United Kingdom to deny tax credits to U.S. corporations that have both U.K. subsidiaries and ties to one of the unitary States of the Union.

U.S.-France treaty

The question of combined reporting requirements of U.S.

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[7] U.S. Exec. Rep. No. 96-5, 96th Cong., 1st Sess. 6 (1979). The House Committee on Ways and Means held a public hearing on the subject (H.R. 5076) on March 31, 1980. The Senate Foreign Relations public committee held a hearing on the subject on September 20, 1984.

States also was discussed in an exchange of notes accompanying a recent protocol to the tax treaty with France. France took the position that for a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a State of the United States, in English, imposes a costly burden. However, no provision regarding this issue was incorporated into the protocol.

Other treaties

Income tax treaties which the United States has entered into with other countries generally contain "nondiscrimination" clauses which prohibit both the Federal Government and the States from imposing on foreign taxpayers heavier tax burdens than are imposed on similarly situated domestic taxpayers. Limitations on State taxation also have been included in a number of Friendship, Commerce, and Navigation treaties of the United States. Of particular relevance here is the commercial treaty with France signed November 25, 1959 (TIAS 4625, 11 UST 2398), which provides in part that companies of either country engaged in the business in the other would not be subject to any form of taxation upon capital, income, profits, or any other basis, except by reason of their operations in that country or any other bases of taxation directly related to their activities within that country. This provision applies to political subdivisions such as the States as well as to the two national governments. Certain foreign-based multinational corporations and certain foreign governments take the position that provisions such as this prohibit the application of the unitary method on a worldwide combination basis in the case of foreign-based multinational covered by the provisions.

IV. ISSUES

Overview

Unlike the Federal Government, States generally tax corporate income according to its source rather than the residence or domicile of the corporate entity (exceptions are made for certain passive income). Source-based taxation requires that income arising within the State be separated from income arising outside of the State. States that impose a corporate income tax generally rely on formula apportionment to allocate domestic income of multistate enterprises among the States. By contrast, for purposes of separating domestic from foreign source income, most States rely on separate accounting rather than formula apportionment. One issue before the Congress is whether the three States that continue to use formula apportionment on a worldwide basis should be required to use separate accounting principles. A second issue is whether and to what extent the States should be permitted to tax foreign source dividends received by State-domiciled corporations. A third issue is the appropriate balance between the States' right to tax and the conduct of foreign policy.

Formula Apportionment vs. Separate Accounting

In general

Under separate accounting, a corporation (or a related group of corporations) is required to treat in-state and out-of-state operations as separate unrelated firms. Movements of goods or intangibles between an in-state and an out-of-state affiliate are treated as sales or licenses and must be recorded at arm's-length prices. Similarly, out-of-state affiliates must bear an appropriate share of centralized management and other overhead costs, determined on an arm's-length basis.

Under Federal tax principles, arm's-length prices are measured by reference to comparable transactions between unrelated parties where such comparable uncontrolled prices ("CUPs") can be found. In practice, many products, or the terms and conditions of their sale, are unique and no CUP can be identified. Intangibles such as patents, copyrights, trademarks, goodwill, and know-how present difficult pricing problems. Moreover, the portion of overhead costs such as central office expense, research, and interest expense that would be borne by in-state and out-of-state affiliates acting

as unrelated parties cannot be determined unambiguously.[8]

By adopting formula apportionment of domestic income, the States have sought to avoid conflict among themselves and with taxpayers with respect to the determination of arm's-length prices. Under domestic formula apportionment, the combined domestic income of the in-state and out-of-state affiliates comprising a unitary business need not be accounted for separately on a State-by-State basis. Instead, combined unitary income (other than items that are specifically allocated) is apportioned between States according to objective factors such as property, payroll, and sales within each State.

While formula apportionment has achieved widespread acceptance for purposes of domestic apportionment, considerable controversy has arisen over its use by certain States for separating domestic and foreign source income of multinational corporations. Critics of "worldwide combination" contend that it (1) apportions too much income to domestic source and as a consequence results in double taxation relative to separate accounting, and (2) imposes substantial administrative costs.

Double taxation

Worldwide combination apportions more income to U.S. source than separate accounting if the ratio of profit (measured on a separate accounting basis) to apportionment factors is higher abroad than in the United States. This can occur, for example, if inputs such as property and payroll are cheaper abroad, or if management systematically requires higher profit ratios from offshore operations to compensate for greater risks.

A Treasury study using taxpayer information for the 1980 tax year estimated that on a national basis, domestic source income under worldwide combination would be 11.7 percent greater than under separate accounting.[9] Only in the

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[8] Robert Tannenwald states that, "Even when reported transfer prices are reasonable or comparable market prices are easily identifiable, separate accounting often fails because it attempts to separate the inseparable. For example, the very fact that an enterprise is vertically integrated reduces its costs, so that its profits are significantly greater than the sum of the profits its components would earn if they were unaffiliated." See "The Pros and Cons of Worldwide Unitary Taxation," Tax Notes (November 12, 1984) p. 650. (Reprinted from the New England Economic Review.)

finance, insurance and real estate industry group did Treasury find that worldwide combination would apportion less income to domestic source than separate accounting. Another study using Commerce Department data for 1977 found that domestic source income under worldwide combination would be 13.5 percent greater than separate accounting.[10] This study, however, found greater interindustry variation and concluded that excluding petroleum and coal producers, "... 1977 taxable income of U.S.-based multinationals would have been 2.4 percent lower under the worldwide combination regime."

The empirical evidence described above supports the contention that worldwide combination overstates domestic source income in aggregate; however, the opposite result may occur for particular companies and industries. If worldwide combination results in overtaxation, separate accounting is one possible remedy. Alternatively, the States that use worldwide combination could modify their apportionment formulas to reduce U.S. apportionment without abandoning the principle of worldwide combined accounting.

Even if worldwide combination results in greater domestic source income than separate accounting, U.S.-based multinationals are not disadvantaged relative to foreign-based multinationals with respect to U.S. operations as long as the foreign parents of domestic companies are included in the worldwide combined report.

Administrative burden

Critics of worldwide combination contend that it imposes a heavy compliance burden on multinational corporations. For example, the New York State Bar Association Tax Section identifies the following compliance issues: "... (1) the need to translate foreign currencies into United States currency; (2) the unavailability of information needed to construct the apportionment formula; (3) laws of foreign countries often prevent the disclosure of information needed to construct the apportionment formula; and (4) different accounting systems

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[9] U.S. Dept. of the Treasury, Office of Tax Analysis, "Comparison of Various Options on the Treatment of Dividends," unpublished paper prepared for the use of the Task Force of the Worldwide Unitary Taxation Working Group. The study is limited to U.S. multinationals and their controlled foreign corporations and excludes payroll factors. (Text shows domestic base under separate accounting as 89.5 percent of worldwide combination which implies that the domestic base under worldwide combination is 111.7 percent (1/.895) of the separate accounting base.)

[10] Tannenwald, Robert. op. cit.

in use in different countries must be conformed to a United States tax accounting system."[11]

Proponents of worldwide combination have noted that a domestic-based multinational is required for Federal tax purposes to provide most of the information that is required for purposes of worldwide combined accounting, since the Federal Government taxes income derived by U.S. corporation on a worldwide basis and requires certain foreign subsidiaries to file information returns with their U.S. shareholder that contain information similar to that required by worldwide unitary reporting. Thus, the additional administrative burden imposed by the worldwide unitary method is primarily attributable to foreign-based multinationals.

In addition, proponents observe that the separate accounting principles in the Internal Revenue Code cause significant administrative burden and uncertainty. A General Accounting Office ("GAO") study of the Federal taxation of multinationals found,[12]

> "Making income adjustments using the arm's length standard has posed administrative burdens on both IRS and corporate taxpayers. Because of the structure of the modern business world, IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. A constructed price is at best an estimate. Because Treasury regulations do not provide sufficient guidance, corporate taxpayers lack reasonable assurance concerning how income on intercorporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers."

Moreover, the separate accounting method in the Code relies on formula apportionment to determine the source of certain expenses (sec. 861 and Treas. Reg. sec. 1.882-5). General and administrative expenses (G&A) and research expenses are apportioned between U.S. and foreign source on the basis of income or sales, and interest is apportioned on the basis of income or assets. (Under the Tax Refom Act of

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[11] New York State Bar Association Tax Section, Committee on Interstate Commerce, "Report on Legislation Prohibiting State Taxation on a Worldwide Unitary Basis," Tax Notes (August, 25, 1986) pp. 817-824. Quoted material appears on page 821.

[12] U.S. GAO, IRS Could Better Protect U.S. Tax Interest in Determining the Income of Multinational Corporations, GGD-81 (September 30, 1981) p. v.

1986, H.R. 3838, interest may be apportioned only on the basis of assets.) In the case of possessions corporations, income from intangibles may be apportioned between U.S. and foreign source using one of two elective formulary methods (sec. 936(h)). Thus proponents of worldwide combination argue that the Federal tax system uses a mixture of separate accounting and formula apportionment to determine the source of income.

In addition, proponents of worldwide combination argue that the State burden of administration could be increased if the States are required to use separate accounting since the States would have to apply rules similar to IRC section 482, and information from related party transactions is not available to the States (e.g., exchange of information agreements generally do not include States, and confidentiality of Federal information does not allow access by States).

Critics respond that even if it is conceded that separate accounting under Federal principles is not inherently less burdensome than worldwide combination, since U.S. companies must compute Federal tax liability in any event, the States should not impose an additional compliance burdens on taxpayers by requiring the use of an entirely different method for sourcing income on State tax returns. However, many States do not follow Federal tax rules with respect to the taxation of wholly domestic firms. For example, depreciation methods permitted by the States are often less accelerated than the accelerated cost recovery system enacted in 1981. Thus, the burden on taxpayers resulting from differences in Federal and State tax rules may not be sufficient reason to impose Federal restrictions on the unitary method.

80/20 companies

For Federal tax purposes, 80/20 corporations are U.S. corporations which derive at least 80 percent of income from foreign sources as measured by Federal source rules. By contrast, the 80/20 corporations referred to in the options developed by the Worldwide Unitary Taxation Working Group are U.S. corporations with at least 80 percent of property and payroll outside of the United States. The July 1984 report of the Worldwide Unitary Taxation Working Group expressed a consensus among participants that separate accounting should be adopted by the States. However, participants disagreed about the appropriate treatment of 80/20 companies under separate accounting principles.

The arguments for and against worldwide combination generally apply with equal force to the question of whether 80/20 companies should be included in the combined taxable income of a unitary business. A number of States that

in use in different countries must be conformed to a United States tax accounting system."[11]

Proponents of worldwide combination have noted that a domestic-based multinational is required for Federal tax purposes to provide most of the information that is required for purposes of worldwide combined accounting, since the Federal Government taxes income derived by U.S. corporation on a worldwide basis and requires certain foreign subsidiaries to file information returns with their U.S. shareholder that contain information similar to that required by worldwide unitary reporting. Thus, the additional administrative burden imposed by the worldwide unitary method is primarily attributable to foreign-based multinationals.

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[11] New York State Bar Association Tax Section, Committee on Interstate Commerce, "Report on Legislation Prohibiting State Taxation on a Worldwide Unitary Basis," Tax Notes (August, 25, 1986) pp. 817-824. Quoted material appears on page 821.

[12] U.S. GAO, IRS Could Better Protect U.S. Tax Interest in Determining the Income of Multinational Corporations, GGD-81 (September 30, 1981) p. v.

generally support the use of Federal tax principles for separating domestic and foreign source income (i.e., the water's-edge principle), nevertheless wish to reserve the right to apportion the income of 80/20 companies. Critics of worldwide combination believe that Federal tax principles should be followed consistently.

Taxation of Foreign Source Dividends

While only three States currently employ worldwide combination, 27 States tax to some extent foreign source dividends.[13] Thus, many more States would be affected by a Federal limitation on the right of States to tax foreign source dividends than by a limitation on worldwide combination.

State taxation of foreign source dividends is a notable exception from the general principle of taxing income according to its source. The taxation of foreign source dividends varies significantly from State to State. Some States allocate while others apportion dividends. In either case, the inclusion of foreign source dividends in the State income tax base may result in multiple corporate-level taxation of the income giving rise to the dividend. This may occur because foreign source dividends are paid out of income which may be subject to foreign income tax, and the dividend itself may be subject to foreign withholding tax at the time of repatriation. Unlike the Federal Government, the States do not provide a tax credit for foreign taxes deemed paid with respect to foreign source dividends to prevent double corporate-level taxation.

State taxation of foreign source dividends has been criticized on the grounds that it can result in a higher tax burden being imposed on U.S.-based relative to foreign-based multinationals. To the extent that this occurs, U.S.-based multinationals arguably are at a competitive disadvantage compared to foreign multinationals.

Proponents of State taxation of foreign source income argue that (1) there is no constitutional prohibition against such taxation, (2) companies are free to switch State domicile to avoid such tax, (3) restricting the State right to tax foreign source income will result in higher taxes on domestic corporations, and (4) State practices do not harm national interests.

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[13] Statement of John D. LaFaver, Chairman, Multistate Tax Commission, before the Subcommittee on Taxation and Debt Management, U.S. Senate Committee on Finance, September 29, 1986.

Proponents also contend that State tax rules allow deductions for costs such as G&A, research, and interest which generate income from foreign subsidiaries. Consequently, inclusion of foreign source dividends in the State tax base is necessary to match income and expense. Critics of the State view argue that Federal tax principles require apportionment of certain U.S.-incurred overhead expenses to foreign sources, and that the States can achieve matching of income and expense without including foreign source dividends by following Federal source principles.

S. 1113 and S. 1974 would require partial or, in some cases, complete exclusion of intercorporate foreign source dividends from State taxation. These bills appear to strike a compromise between allowing States to tax fully foreign source dividends and requiring that such dividends be excluded from State taxation. Critics contend that no tax policy principles justify the arbitrary formulas for determining the exclusion percentages in these bills.

Foreign Policy Considerations

A number of the nation's leading trading partners have expressed substantial concern about the use by certain States of worldwide combined reporting. In addition, threats of retaliation have been made. In part as a response to foreign policy considerations, the Worldwide Unitary Taxation Working Group was established in 1983 under the President's directive. Following the report of the Working Group in July of 1984, some States have repealed worldwide combination, most notably California. However, retention of worldwide combination by three States may be a source of continuing international friction that could adversely affect trade and treaty negotiations.

By contrast, foreign governments do not appear to be very concerned about the U.S. tax treatment of foreign source dividends, presumably because such taxes fall primarily on U.S.-based rather than foreign-based multinationals. Thus, the imposition of Federal limitations on State taxation of foreign source dividends is unlikely to have any significant effect on the conduct of U.S. international economic policy.

V. DESCRIPTION OF S. 1113 (Senator Mathias)

A. Prohibition of Worldwide Combination

The first part of S. 1113 generally would prohibit the States (or their political subdivisions) from taking into account, through the application of a worldwide unitary combination method or by any other method, the income of foreign affiliates of corporations doing business within the States and unless that income is subject to Federal income tax. The corporation doing business within, and subject to tax by, the State generally would be a corporation organized under U.S. law, but it also could be a foreign corporation operating through a U.S. branch. In the following discussion of S. 1113, the term "taxable corporation" is used to refer, in either case, to the corporation doing business in the State.

As an exception to this general rule, the State or locality may include in the income of a U.S. corporation any income of a foreign corporation which is includible in the U.S. corporation's income for Federal purposes under the income tax provisions of the Code. For example, tax haven income of a controlled foreign corporation which under subpart F (Code secs. 951-964) is includible in the U.S. corporation's income for Federal tax purposes[14] also could be taxed at the State or local level (subject, however, to the bill's special rules regarding dividend income discussed in the following section).

The legislative proposal thus would prohibit, for example, the use of the worldwide combination method of reporting. Under that method, the income of foreign affiliates of a corporation subject to tax in a State is included in total income subject to apportionment if the activities of the two corporations are part of a unitary business. (The property, payroll, and sales of foreign corporations frequently are taken into account also in determining the amount of income apportionable to a State using the worldwide combination method of reporting.) This part of S. 1113 would not affect the application of the

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[14] Under subpart F, a foreign corporation generally is a controlled foreign corporation (CFC) if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom owns at least 10 percent of the voting power. The U.S. shareholders generally are required to include currently in their income (as a constructive dividend) their pro rata shares of certain undistributed tax haven and passive income of the CFC.

unitary method by those States which generally do not include the operations of foreign affiliates in the combined report. However, to the extent that such States actually tax foreign earnings when they are received as dividends, the provisions of S. 1113 regarding dividends received from foreign affiliates (discussed below) would apply.

For purposes of the bill, an "income tax" is defined as any tax which is imposed on, according to, or in relation to an amount measured by net income. Thus, for example, a tax on the privilege of doing business in a State in a corporate form which is measured by net income would be an income tax. For purposes of determining whether the taxable corporation and a foreign corporation are affiliated, the bill defines the term "affiliated group" to mean a common parent corporation and one or more chains of corporations connected through stock ownership with the common parent corporation.

Certain corporations organized under U.S. law would be treated as foreign corporations for purposes of the bill, and, thus, their income generally could not be taken into account in determining the liability of the taxable corporation. A domestic corporation generally would be treated as foreign if less than 20 percent of its gross income for the preceding three years was from sources within the United States. (Such corporations generally are referred to as "80/20 companies"). Included in this category would be possessions corporations (Code sec. 936).

B. Exemption for Dividends from Foreign Sources

The bill also would prescribe a partial or complete exemption for dividends received by U.S. corporations from (1) foreign corporations and (2) U.S. corporations 80 percent of whose income is from foreign sources. These exemptions apply whether or not the corporations paying and receiving the dividends are affiliated.

Dividends from foreign corporations.--In the case of dividends received from a foreign corporation, the bill would provide that the amount of income to be taken into account may not exceed the lesser of (1) the actual amount of the dividend received, net of any foreign income taxes on the income but not reduced by foreign withholding taxes, or (2) a formula amount intended to take into account foreign taxes imposed on the dividend or on the income from which the dividend is paid.[15]

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[15] The following discussion assumes that the taxable corporation elects to credit, rather than deduct, foreign income taxes and that it has the 10-percent or larger interest in the foreign corporation required in order to

(Footnote continued)

The net effect of this limitation would be that where the aggregate rate of foreign income taxes paid by a U.S. corporation with respect to the dividends it receives from its foreign subsidiaries (grossed up by the foreign income taxes paid by the foreign subsidiaries which are attributable to the earnings distributed to the U.S. parent corporation) equal or exceed the present 46-percent U.S. Federal income tax rate, no part of the dividends received by the U.S. corporation from its foreign subsidiaries could be taxed by a State. Where the aggregate foreign tax rate is less than 46 percent, a proportionate part of the dividends would be exempt from State income tax (if the foreign rate is half of the Federal rate, half the grossed-up foreign dividends would be exempt; if the foreign rate is one-quarter of the Federal rate, one-quarter of the grossed-up foreign dividends would be exempt, etc.). Since many U.S. corporations pay (or are deemed to have paid) foreign income tax with respect to dividends from foreign subsidiaries at rates comparable to the 46-percent U.S. Federal income tax rate (determined on an overall basis for all dividends received by the U.S. corporation from foreign affiliates), it can be expected that, for many U.S. corporations, the bill would exempt from State income taxes most if not all of the dividends they receive from foreign corporations. (However, under the Tax Reform Act of 1986 (H.R. 3838), the Federal corporate income tax rate is reduced to 34 percent after 1987.)

The formula limitation is determined as follows: The first step under the formula is to determine the "grossed up" amount of the dividend by adding to the amount of the dividend the foreign income taxes paid by the distributing foreign corporation which are attributable to the dividend. This "grossed up" dividend amount is then multiplied by a fraction to determine the portion of the dividend to be excluded in determining the U.S. corporation's liability under the formula. The fraction takes into account not only the particular dividend under consideration but all dividends received during the year from foreign corporations by the U.S. corporation. The numerator of the fraction is the sum of (1) the foreign taxes imposed on the income of the foreign corporations from which the dividends are paid and (2) any additional foreign tax withheld on the payment of the dividends to the U.S. corporation. The denominator of the fraction is the grossed-up amount of all foreign dividends multiplied by 46 percent, the highest corporate rate presently in effect at the Federal level.

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[15](continued)
claim the foreign tax credit for taxes paid by the foreign corporation which are attributable to the dividend (see Code secs. 902 and 960).

The operation of this formula is illustrated in the following example. Suppose that a foreign country imposes a net corporate income tax at a flat rate of 23 percent (half the current U.S. Federal rate) and imposes no withholding tax on the distribution of dividends. A foreign corporation earns $100 in that country, pays the foreign income tax of $23, and remits the remaining $77 to the U.S. corporation whose State tax liability is to be determined. The actual amount of the dividend is thus $77. The amount taxable under the formula is determined as follows. First, the $77 received is grossed up to include the $23 of foreign tax imposed on the income from which it was paid, for a total of $100. The portion to be excluded is determined by multiplying the grossed-up dividend amount ($100) by a fraction, the numerator of which is $23, the foreign tax paid, and the denominator of which is $46, the maximum U.S. corporate rate of tax on the $100 of income.[16] The resulting product is $50 ($100 X $23/$46), the excludable amount (half the grossed-up dividend). Thus, $50 ($100 minus the excluded $50) is subject to tax under the formula. Because this is less than $77 actually received, the State may not include more than $50, the amount determined under the formula, of the dividend in the U.S. corporation's income.[17]

If the foreign country's tax rate had been 46 percent, then the actual dividend received by the taxable corporation would have been $54. The grossed-up dividend under the formula would have been $100 ($54 plus $46). The excluded amount would have been $100 ($100 multiplied by $46/$46). Thus, none of the dividend would have been subject to tax by

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[16] The 5-percent surtax imposed on certain corporate income (to phase out the benefit of graduated corporate rates) is disregarded under the formula in S. 1113.)

[17] The actual amount of a dividend may be smaller than the formula amount if the taxable corporation also receives other dividends during the taxable year. This may be illustrated by returning to the example in which the foreign country imposed a 23 percent tax on corporate income and assuming that the U.S. corporation also received a dividend of $900 from another foreign affiliate during the year from which a foreign income tax of 5 percent ($45) was withheld. Under the formula, the grossed-up amount of the first dividend ($100) would be multiplied by a fraction, the numerator of which is the total foreign income taxes paid ($23 plus $45, or $68), and the denominator of which is 46 percent of the total grossed-up dividends (46 percent of the sum of $100 and $900, or $460). The excludable amount would thus be the product of $100 and $68/$460, or $15, and the taxable amount under the formula would be $85 ($100 minus $15). In this case, the actual amount of the dividend ($77) would be less

(Footnote continued)

the State.

The operation of these provisions is illustrated by the following example which compares the total income tax burden (State, Federal, and foreign) on $100 of income earned by a U.S. company with the total tax burden under the bill on $100 of income earned by a foreign affiliate of the U.S. company and paid to the U.S. company as a dividend. The State tax rate is 10 percent. In the case of U.S. operations, the U.S. tax base is $90 after deduction of State tax of $10.

	Taxation of operations in United States only	Taxation of foreign source dividends at different foreign tax rates			
		Zero	23%	46%	50%
Foreign tax	0	0	$23	$46	$50
Net U.S. tax (46%)	$41.40	$41.40	20.70	0	0
State tax (10%)	10	10	5	0	0
Total taxes	51.40	51.40	48.70	46	50

This example shows that under S. 1113 the total (State, Federal, and foreign) income tax burden of the foreign affiliate declines as the foreign income tax rises from zero to 46 percent.

Foreign source dividends from 80/20 companies (other than sec. 936 corporations).--In the case of foreign source dividends received from an 80/20 company other than one making an election under Code section 936, the bill would limit the amount of income permitted to be taken into account under the same rules applicable to dividends from a foreign corporation (discussed immediately above), applied separately to the 80/20 dividends and modified as follows: First, the numerator of the fraction used in computing the formula limitation would include, in addition to any foreign taxes withheld on the payment of dividends by the 80/20 company (and any other 80/20 companies paying dividends to the U.S. corporate recipient during the year), foreign income taxes paid or deemed paid by the 80/20 company (and any other 80/20 companies paying dividends to the U.S. corporation during the

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[17](continued)
than the formula amount, and would be the maximum subject to State or local tax. As to the $900 dividend, the actual amount of the dividend is $900. Under the formula, the exclusion is the product of $900 and $68/$460, or $133. Thus the formula limit is $767, which is less than $900 and thus would apply. The total amount which could be included in the U.S. corporation's income with respect to the two dividends would be $844 ($77 plus $767).

year), in the same proportion with respect to the accumulated profits of each 80/20 company which the amount of the dividend bears to the amount of those accumulated profits in excess of all income taxes (other than those deemed paid). This modification ensures that, in the case of dividends paid by 80/20 companies, the numerator of the fraction includes all foreign taxes imposed on the income of 80/20 companies from which the dividends are paid. This additional inclusion of foreign taxes in the numerator is not conditioned upon the dividend recipient's ownership of 10 percent or more of the dividend payor's voting stock, as is the inclusion in the numerator of deemed paid foreign taxes in the case of dividends from foreign corporations.

Second, the dividend amount taken into account in the denominator of the fraction is grossed up by the additional foreign taxes just described. Third, the dividend amount multiplied by the fraction is grossed up by the portion of the additional foreign taxes just described that was actually paid or deemed paid by the dividend payor (as opposed to other dividend-paying 80/20 companies in which the U.S. corporate recipient owns stock).

Foreign source dividends from section 936 companies.--A separate rule would apply to exempt foreign source dividends received from an 80/20 company which makes an election under Code section 936 (a "section 936 company"). Unlike the rules which would apply to dividends from other 80/20 companies and foreign corporations, relief under this provision does not depend on the amount of foreign income taxes which the dividend bears. A State or locality would not be permitted to take into account the amount of any dividend received from a section 936 company to the extent that the recipient corporation is allowed a dividends received deduction under the Code. The dividends received deduction for dividends paid by a section 936 company generally is equal to 100 percent of the dividend.

C. Other Rules

Foreign taxes for which a credit is allowed under the Code's creditability rules (Code sec. 901) would be the only foreign taxes to be taken into account in applying the foregoing rules.

The bill would not subject any dividend, other income item or portion thereof to taxation, if that taxation is otherwise prohibited by any law, or rule of law, of the United States.

D. Effective Date

The provisions of S. 1113 would apply to taxable periods (under State or local law) beginning after December 31, 1986.

VI. DESCRIPTION OF S. 1974 (Senators Wilson, Mathias, and Hawkins)

S. 1974 was introduced at the request of the Administration. While its language in some respects follows draft language issued on July 8, 1985, by the Treasury Department to implement the recommendations of the Worldwide Unitary Taxation Working Group, S. 1974 differs in several major ways from the Working Group recommendations. (A companion bill, H.R. 3980, was introduced in the House of Representatives by Mr. Duncan.)

A. Prohibition of Worldwide Unitary Method

The bill generally would bar imposition by any State of an income tax on any taxpayer on a worldwide unitary basis. (In this respect, the bill differs from the Working Group recommendation, which would have allowed Federally obtained tax information to only those States that do not use the worldwide unitary method, but which would not have barred use of that method.) The bill defines worldwide unitary basis to mean that, in computing its State income tax liability, a corporation would take into account the income of another corporation, unless that second corporation both is a member of the same controlled group of corporations (control generally being defined as more than 50-percent common ownership) and is one of five kinds of corporations that may be part of a "water's edge group" (described below).

In two cases, however, a State could impose income tax on a worldwide unitary basis. First, if a taxpayer makes an unconditional election to be taxed on a worldwide unitary basis, a State may permit a taxpayer to be taxed on that basis. Second, a State may impose tax on a worldwide unitary basis if (1) the taxpayer materially fails to comply with certain compliance provisions of this bill, discussed below, or with the legal or procedural requirements of the State's income tax laws, or (2) neither the taxpayer nor the government of the relevant foreign country provides to the State, within a reasonable period after proper request, material information relating to the determination of the taxpayer's income on transactions between the taxpayer (or a related corporation within the water's edge group) and any related corporation that is not in the water's edge group.

The bill defines income tax to include any State franchise or other tax which is imposed upon or measured by the income of the taxpayer.

B. Foreign Source Dividends

As to dividends received by corporations from corporations outside the water's edge group, a State (other than the State of commercial or legal domicile of the

corporation receiving the dividends) would not require the inclusion in income, for State income tax purposes, of more than an "equitable portion" (a defined term) of any such dividend. (The Unitary Working Group did not take a position on this issue.) For this purpose, a State will not be considered to include in its income base more than an "equitable portion" of dividends from corporations outside the water's edge group if it satisfies any of three tests.

First, it will satisfy this "equitable portion" requirement if it excludes from its income base at least 85 percent of those dividends (the same percentage as the current Federal deduction for dividends received from non-80-percent owned corporations, which applies generally to dividends from U.S. corporations but only in limited circumstances to dividends from foreign corporations). Second, it will satisfy this requirement if it excludes from its income base the portion of the dividend that effectively bears no Federal income tax by virtue of the foreign tax credit. This method is like that mandated by S. 1113, described above. Third, it will satisfy this requirement if it adopts a method of taxation, pursuant to regulations to be promulgated by the Secretary, that, considering all the facts and circumstances, results in an equitable apportionment of the dividend to the State substantially similar to the 85 percent exclusion or the exclusion that is analogous to the foreign tax credit. This provision does not permit State taxation of any dividend not subject to State taxation prior to enactment of the bill.

This limitation on taxation of dividends would apply not only to dividends from related parties, but also to portfolio dividends earned from passive investments, including portfolio dividends from foreign corporations.

C. Water's Edge Group

As indicated above, five kinds of corporations make up the water's edge group (that can be taxed under a combined unitary reporting method under the bill). The first kind of corporation in the water's edge group is a U.S. corporation, including a corporation that has made an election under section 936 (which primarily benefits Puerto Rico) to be treated as a possessions corporation. Under an exception described below, some U.S. corporations whose U.S. activities are below certain thresholds are excluded from the water's edge group. The second kind is a Foreign Sales Corporation entitled to certain U.S. tax benefits on sales of export property (described in sec. 922 of the Code). The third kind is a corporation organized in Puerto Rico, Guam, American Samoa, or the U.S. Virgin Islands.

The fourth kind of corporation included in the water's edge group is a foreign corporation with substantial U.S.

presence. To come within the water's edge group under this test, the foreign corporation must be subject to State income tax in at least one State by virtue of its business activities there. In addition, before it becomes a member of the water's edge group under this test, the foreign corporation must have activities in the United States rising to a certain dollar threshold or a percentage threshold. Under the dollar threshold, a foreign corporation becomes eligible for inclusion in the water's edge group if it has, assignable to one or more locations in the United States, at least $10 million in compensation payments made by it for services rendered during its most recent Federal taxable year, sales or purchases of at least $10 million to or from unrelated parties during its most recent Federal taxable year, or property (other than stock or securities of a corporation) with an aggregate original cost of at least $10 million. A corporation comes within the water's edge group if the average of the percentages of the foreign corporation's property (based on its aggregate original cost), compensation payments made for personal services (determined for its most recent Federal taxable year), and sales (determined for its most recent Federal taxable year) that are assignable to one or more locations in the United States is at least 20 percent.

The fifth kind of corporation that can be a member of a water's edge group is a foreign corporation that neither performs substantially independent activities nor is subject, under standards established and regulations to be prescribed by the Secretary, to substantial foreign tax on its net income. Corporations included under this fifth test are sometimes referred to a "tax haven" corporation. To be included in the water's edge group under this fifth test, a foreign corporation must be a member of a controlled group that includes a "reporting corporation" (described below to include corporations with substantial foreign activities or substantial worldwide assets). In addition, a corporation, to be included in the water's edge group under this fifth test, must either carry on no substantial economic activity or make at least 50 percent of its sales, 50 percent of its payments for expenses other than payments for intangible property, or 80 percent of all of its payments for expenses to one or more related corporations that are in the water's edge group by virtue of the first four tests.

For the purpose of determining whether a U.S. corporation is in the water's edge group, a provision of the bill "mirrors" the $10 million/20 percent rule that applies to foreign corporations. Under this mirrored rule, a corporation is treated as a foreign corporation if it satisfies both a dollar amount test and a percentage test. A U.S. corporation satisfies the dollar amount test if it has, assignable to one or more locations in the United States, less than $10 million in compensation payments made by it for

services rendered in its most recent Federal taxable year, sales or purchases of less than $10 million to or from unrelated parties during its most recent Federal taxable year, and property (other than stock or securities of a corporation) with an aggregate original cost of less than $10 million. A U.S. corporation satisfies the percentage test for this purpose if the average of the percentage of its property (based on aggregate original costs), compensation payments for personal services (determined for its most recent Federal taxable year), and sales (determined for its most recent Federal taxable year) that are assignable to one or more locations in the United States is less than 20 percent. This exception could effectively eliminate possessions corporations (sec. 936) from the water's edge group, depending on the determination of the situs of sales of property produced in a U.S. possession such as Puerto Rico and sold into the mainland.

U.S. corporations that are outside the water's edge group under this percentage test are sometimes called "80/20" companies. (These 80/20 companies are to be distinguished from so-called 80/20 corporations for Federal income tax purposes (described in Code sec. 861(a)(2)(A)), whose interest and dividend payments are generally treated as foreign source under present law. For Federal purposes, the percentage test is based on gross income rather than property, payroll, or sales.) The Working Group took no position on whether these 80/20 companies should be includible in a water's edge group.

In certain circumstances, a U.S. branch of a foreign corporation will be treated as a separate U.S. corporation. First, if the branch of a foreign corporation is engaged in a commercial banking business, it will be treated as a separate U.S. corporation. For this purpose, a branch is engaged in the commercial banking business if the predominant part of its business consists of receiving deposits or making loans and discounts, and it is subject to supervision and examination by State or Federal authorities having supervision over banking institutions. Second, regulations may provide that domestic branches of foreign corporations in specified industries other than banking will be treated as separate U.S. corporations.

D. Reporting Requirements

The bill provides detailed information reporting requirements. (As mentioned previously, a corporation which fails to materially provide the required information may be taxed by a State using a worldwide unitary basis.) A reporting corporation (defined below) must file with the IRS, within 180 days of the due date (including extensions) of its Federal income tax for the taxable year, a return disclosing information relating to its State income tax returns for

State taxable years ending with or within its taxable years for Federal income tax purposes. This return is to include the reporting corporation's income tax liability, each State in which it is liable to pay tax, its income subject to tax in each State, the method of calculation by which the reporting corporation computed and allocated its income subject to tax by each State, and a list of related corporations that have engaged in transactions with the reporting corporations (and the affiliates) aggregating $1 million or more. In addition, the reporting corporation is to furnish such other related information as the Secretary may by regulation prescribe.

If a reporting corporation is the common parent of an affiliated group, in filing the return described immediately above, it is to include the required information with respect to each includible corporation in its affiliated group. If a reporting corporation is a member of a controlled group that includes a foreign corporation that does not carry on substantial economic activity (or that deals primarily with related parties) and that is not subject to substantial foreign net income tax, but is not required to file a Federal income tax return, then that foreign corporation is considered to be a member of the affiliated group of which the reporting corporation is a common parent. No double reporting is required under this rule.

The bill defines a reporting corporation to mean a corporation that is required to file a Federal income tax return for the taxable year and that satisfies either a level of foreign activities test or a level of total activities test. A corporation satisfies the level of foreign activities test if it makes aggregate payments of at least $10 million as compensation for services rendered outside the United States during the taxable year, owns foreign assets with an aggregate original cost of at least $10 million, or has gross sales occurring outside the United States of at least $10 million during the taxable year. It satisfies the level of total activities test if it is subject to tax in at least two States, and owns total assets with an aggregate original cost of at least $250 million, at least $10 million of which are located in the United States. The Secretary is authorized to increase dollar thresholds for this purpose and to allocate compensation payments, property, or sales to (or among) foreign countries. The bill provides for the aggregation of compensation paid by, property owned by, or sales made by related members of corporate groups in determining whether the $10 million or $250 million test is met. In addition, a U.S. branch of a foreign corporation engaged in the commercial banking business in the United States is treated as a separate U.S. corporation for purposes of applying these reporting provisions.

If the information return or any information reflected

thereon is disclosed or made available to a State tax agency or to any common agency (defined to mean a joint or common agency, body, or commission which has been designated under the laws of four or more States to represent those States collectively in the administration of the corporate income tax laws of those States, and which has executed a nondisclosure agreement) in which the State participates, such as potentially, the Multistate Tax Commission, the return is to be treated (if the State law so provides) as if originally filed with that State for the purpose of imposition of the State's criminal or civil penalties for negligence, fraud, or material understatement of income or of tax liability. Except as provided by State law, treatment of the return as a State return will not extend or otherwise affect any State's statute of limitations.

The bill provides a $1,000 penalty for failure to comply substantially with the information reporting requirement. The bill provides that, 90 days after mailing notice of failure to comply, continuing failures are subject to additional penalties of $1,000 for each 30-day period. The total penalty for one continuing failure cannot exceed $25,000.

E. Disclosure of Federal Information

The bill amends the Internal Revenue Code rules governing the confidentiality and disclosure of tax information. The bill provides that upon compliance with certain procedures and requirements (described below), return information with respect to the income tax, the self-employment tax, the consolidated return rules, the estate and gift taxes, the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, wage withholding, retail excise taxes, manufacturer's excise taxes, the excise tax on undistributed income of real estate investment trusts, the windfall profit tax on domestic crude oil, the excise taxes on distilled spirits, wines and beer, the excise taxes on certain tobacco products, and the excise tax on the use of certain highway motor vehicles shall be open to inspection by or disclosure to any State tax agency for the purposes of (but only to the extent necessary for the administration of) the State's tax laws. The same treatment applies to return information obtained by the Internal Revenue Service from a foreign government or agency or department thereof under the exchange of information provisions of any tax treaty or any Caribbean Basin Initiative exchange of information agreement. Information obtained under tax treaties or Caribbean Basin Initiative agreements is to be open to the examination or disclosure only to the extent that the treaty or agreement permits such disclosure.

The staff is unaware of any treaty or agreement that now permits disclosure of tax information to State taxing

authorities. The bill would amend the requirements for exchange of information agreements under the Caribbean Basin Initiative legislation so that such exchange of information agreements must provide for the exchange of such information as may be necessary and appropriate to carry out and enforce the tax laws of the several States of the United States.

Return information described above that relates to a taxpayer that is either a reporting corporation or a member of an affiliated group that also includes a reporting corporation is to be open to disclosure to or inspection by any qualifying common agency such as, potentially, the Multistate Tax Commission.

Except as provided by regulations, inspection is to be permitted or disclosure made to State officials only upon written request by the head of the State tax agency or the common agency, and only to personnel listed in that written request. In no event is disclosure to be made to the Governor of the State or to a person who is not an employee or legal representative of the agency. Disclosure may be made to a person listed in regulations prescribed by the Secretary as necessary in connection with processing, storage, programming, and the like, for purposes of tax administration (under sec. 6103(n) of the Code). There is to be no disclosure to the extent that the Secretary determines that disclosure would identify a confidential informant or seriously impair a tax investigation.

A State agency or common agency obtaining returns or return information described above may disclose those returns or return information to a State tax agency of an other State so long as that other agency has entered into a nondisclosure agreement with the Secretary that prohibits the disclosure of those returns or return information or of any data, information, or conclusion extracted from or based upon these returns or return information except for the purposes and under the conditions provided in the Internal Revenue Code provision governing confidentiality and disclosure of return and return information (sec. 6103). The required nondisclosure agreement is to contain such terms and conditions as the Secretary may prescribe.

These returns or return information obtained by a State tax agency are to be open to inspection by or disclosure to officers and employees of a State audit agency for the sole purpose of making an audit of the State tax agency. State audit agencies are not to have access to return information obtained under a treaty or a Caribbean Basin Initiative Agreement. For this purpose, a State audit agency is any State agency, body, commission, or entity which is charged under the laws of the State with the responsibility of auditing State revenues and programs.

F. Effective Date

The bill would be effective for taxable years beginning after 1986.